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Tax Considerations for Mining Investment

Ali Mardi
ali.mardi@id.pwc.com

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Agenda

- Mining Tax and Royalty Regime
- Investment Structure
- Trends and Challenges

Mining Tax and Royalty Regime

Tax and Royalty Considerations in Mining Investment

- One of the key considerations in mining investment: tax and royalty regime
- Income tax is usually calculated based on net profit
- Various royalty calculation methods
- Income Tax and Royalty regimes need to be well understood for investment decisions (both for new developments or on acquisition)
- Not all countries offer tax stability. A stable competitive tax and royalty regime is one of the key considerations for investments (in particular for regional or global mining houses)
- The life-of-mine (LoM) financial model should reflect the tax and royalty regime properly (including sensitivity analysis). The ability to structure these properly will likely result in a better return (in case of new project) or competitive bid (in case of acquisition)

Income Tax
General

- Income Tax is often calculated based on net profit, i.e. revenue minus deductible expenditure
- Deductible costs typically constitute expenditure related to the project, e.g. mining operating costs, government royalty, fixed asset depreciation, amortisation of deferred exploration expenditure
- Tax and accounting rules may differ (e.g. deduction and timing of cost recognition)
- Income tax facilities may be available for a mining project

Income Tax

Depreciation of fixed assets and amortisation of deferred costs

- Exploration and mine development costs during pre-production can usually be capitalised (until the commencement of production)
- Different depreciation/ amortisation methods result in different cost profiles, which lead to different income tax results.
- The best result is to match the LoM and the depreciation/ amortisation periods, e.g. the unit-of-production method
- Using other depreciation / amortisation methods may result in the company not receiving a full deduction for its costs, e.g. where LoM < depreciation / amortisation period will result in unutilised tax losses

Income Tax
Financing costs

- Financing costs related to mine development, fixed assets and working capital are usually deductible
- Thin capitalization (debt-to-equity) rule may exist to limit interest deductions where the company is highly leveraged
- Watch for any withholding tax (WHT) on interest as offshore financiers often require payment net of any WHT deduction
- Recognition of non-interest financing costs (e.g. commitment fees, upfront fees, etc) may differ between tax and accounting.

Income Tax
Capital lease

- Certain assets (in particular heavy equipment) may be acquired through capital leases
- Important to understand the tax regime applicable for capital leases
- For example, Indonesia treat a capital lease as an operating lease, hence the payment (principal plus interest) is deductible and no depreciation is allowed

Income Tax
Mine operating costs

- Mining operating costs are usually deductible
- Differences between tax and accounting may exists in how the operating costs are recognized, e.g.
  - inventory valuation
  - stripping costs recognition (deferred?)
  - corporate social responsibility costs (public infrastructure, donations, etc)
  - major plant and equipment overhaul costs

Income Tax
Reclamation and mine closure

- Often represents a significant cost when revenue is in declining trend (if not non-existence)
- Will provisions for reclamation and mine closure (including demobilization, employee severance) be deductible?

Income Tax
Facilities

- Any income tax facilities available?
- The facilities may be in the form of:
  - investment allowance (i.e. additional deduction for capex)
  - accelerated depreciation/ amortisation
  - reduced income tax rate
  - tax holiday
  - tax allowance
- Need to investigate both the technical requirements and practical experience in accessing the facility

Income Tax
Tax losses

- Mining operations may not record any taxable profit for the first few years of operations
- The question is:
  - whether there is a “ring-fencing” rule
  - how long a tax loss may be carried forward?
- If tax loss carried forward is available, will the company be able to utilize it? Can any actions be taken by the company to preserve the expiring tax losses?
- In an asset/ share acquisition, will tax losses be preserved upon “change of control”?

Royalty

- Methods: unit based/ specific, ad valorem, profit based
- Unit based/ specific: based on a fixed dollar per tonne/ oz/ lb of production. There could be progressive rates based on production level
- Ad valorem: percentage of the royalty price per tonne/ oz/ lb. There could be progressive rates based on the price range
- Profit base: percentage of the net profit (like income tax)
- The ad valorem royalty is generally preferred by governments as they will enjoy higher royalties when the price is high without any impact of operating costs (but the downside is that when the price is down, the royalty amount will also decrease – hence some governments may impose the "floor royalty rate" to ensure it receives a minimum amount)

Other Taxes to Consider

- There could be other taxes that will impact the economics of the mine
- Import duty and taxes: will import of plant and equipment be subject to these?
- GST or VAT: will this become an additional cost for the project? if refundable, what is the typical refund period?
- Regional/ federal taxes: regional/ federal taxes may be a lump-sum amount per annum or depend on production or the concession area
- Other fees: any other government fees that may impact the project?
- Will any of the additional taxes/ fees described above be deductible?

Investment Structure

Investment Stucture

- Any investors would need to consider the investment structure upfront as it will impact future profit/ cash repatriation and exit
- Areas to consider:
    - shareholding structure
    - financing structure
    - (post deal) restructuring and integration

Investment Stucture
Shareholding

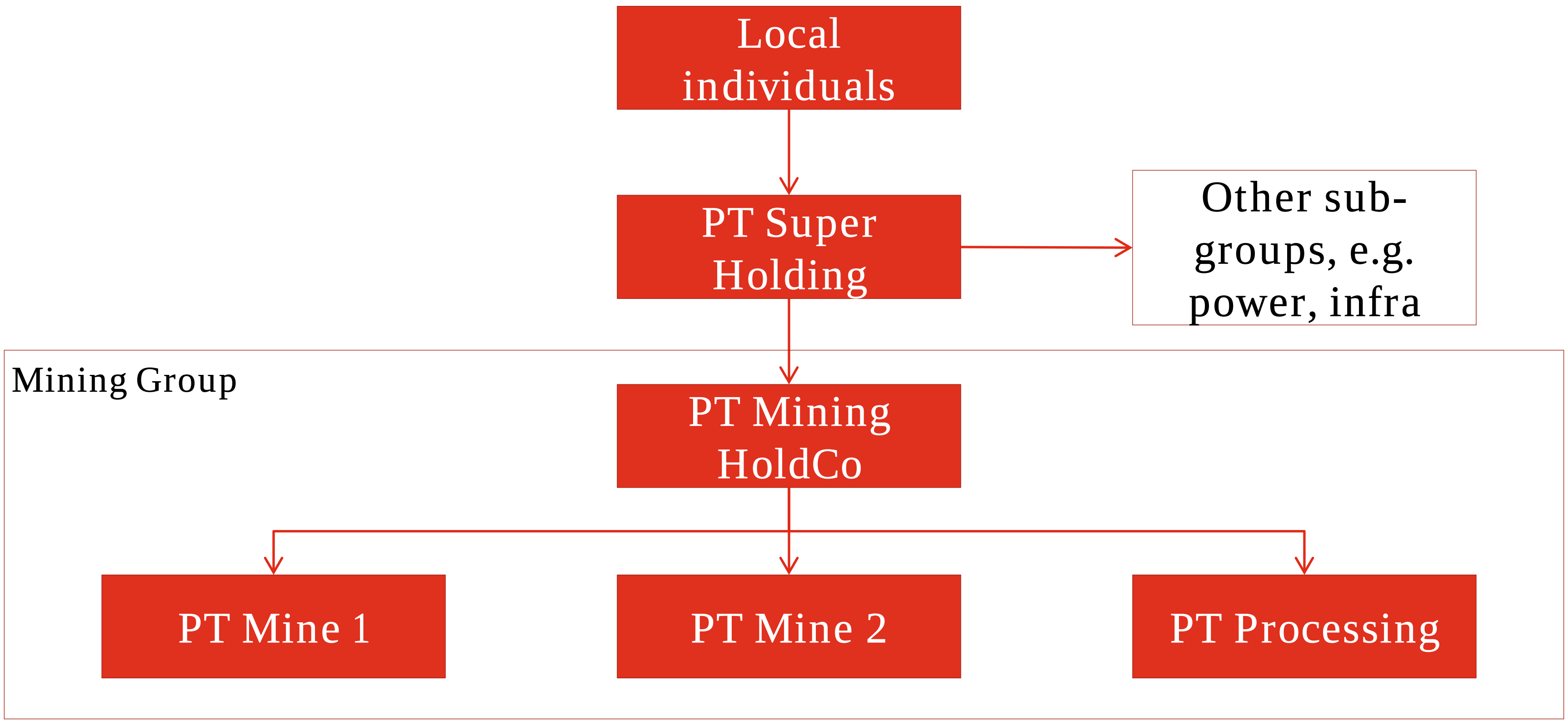
Local group

- For a local group, it is important to understand whether there is:
  - income tax consolidation
  - income tax on dividends between local companies
  - tax relief on local group restructuring
  - tax/ duty on exit (asset vs share transfer)
- For example, in Indonesia there is no income tax consolidation or tax relief on restructuring. However, local intercompany dividends may be income tax exempt. Therefore, the most preferred structure is to have a holding company with subsidiaries that hold CoWs or IUPs. This holding company will accommodate future financing (own cash, loan or Bond issue) and IPO.

Investment Stucture
Shareholding (continued)

Local Group

- A typical Indonesian group structure:



Investment Stucture
Shareholding (continued)

Foreign investment

- Dividend repatriation: any dividend WHT in the foreign country? If yes, what is the rate and can any tax treaty benefits be obtained?
- Home country tax: any further tax on dividends received from the foreign subsidiaries? If yes, will the WHT in the foreign country be creditable?
- Any Controlled Foreign Company (CFC) rules that may deem dividends to have been repatriated from the foreign subsidiary irrespective of dividend declaration?
- Should the company hold the shares in foreign subsidiaries through another subsidiary residing in a jurisdiction with favorable tax treaty? Watch the anti tax-treaty abuse and "beneficial ownership" rules
- Any tax/ duty on exit? Asset vs share deal? Both in foreign jurisdiction and the shareholder's jurisdiction?

Investment Structure
Financing

- The question is: what is the right debt to equity ratio? is there any legal requirement to maintain certain level of equity?
- Any non-deductible interest represents additional income tax cost and, in case of shareholder loan, potentially additional WHT (interest that is deemed as dividend may be subject to a different WHT rate)
- What are the transfer pricing rules on shareholder loan interest? Greenfield projects usually require non-interest bearing shareholder loans, is this possible?
- Will financing costs related to mine acquisition be deductible at a project level (debt push down)?

Investment Structure

(Post-deal) restructuring and integration

- Post investment decision, there may be a need to reorganize and integrate new operations with the existing ones
- Best practice: no future re-organization, but this may not always be possible. The key is to understand the required re-organization and its tax implications
- Integration of the existing operations may also have tax implications, e.g. shared services, integrated procurement, or a merger

Trends and Challenges

Regional Competitiveness

- Many countries in Asia Pacific are (potentially) big mining countries, e.g. China, Mongolia, India, Indonesia, the Philippines, PNG and Australia
- The Fraser Institute conducts annual Survey of Mining Companies. Based on the 2011/ 2012 survey:
  - many of the above countries are top rank in terms of mineral potential
  - however, from policy perspectives, these countries are ranked low and the survey has identified significant room for improvement, which is unfortunate because developing nations need the new jobs and increased (sustainable) prosperity that mining can bring
- The policy includes tax policy for mining. A competitive mining tax and royalty regime is necessary as one key factor to attract investments. But the challenge has always been on how to find the balance of the people/ country interests and those of the investors

Regional Competitiveness (continued)

- Since the 2008 crisis, some governments have raised taxes/ royalty or are considering to raise tax/ royalty revenue from the mining industry. The global trend is an increase in overall tax burden on mining companies
- Many stakeholders are reviewing the current mining operations based on the current yardstick (e.g. economic development, commodity price) rather than the conditions when the mining investments were made, which put more pressure on mining sector to “give” more to the government
- Potential changes in the tax/ royalty regime should be included in the LoM financial model sensitivity analysis

Mining Tax Disclosure Policy

- Tax disclosures are now required for SEC registered companies (Dodd Frank tax and royalty disclosure):
  - applicable for all SEC "resource extraction issuers", regardless of size, effective 30 September 2013
  - covers taxes, royalties, fees, production entitlements, bonuses, dividends and infrastructure payments to government (cash basis) by project (not defined)
- Gathering the information from multiple jurisdictions can be a challenge
- This may be followed by other regions, e.g. EU Directives (proposed), EITI framework, and Publish What You Pay (PWYP)
- In summary, more tax and royalty disclosure requirements are likely for extractive industry. The question is always: does the industry pay its fair share?
- For those who are SEC registrant or a subsidiary of an SEC registrant, need to start investigating the impact

Transfer pricing

- Transfer pricing is currently a hot issue in the region
- Improper policy on related party transactions may result in significant tax assessments and penalties
- The general principle is that any related party transactions need to be at arm’s length pricing
- The challenge is often to find the independent benchmarks and on how to manage during a tax audit
- Early identification of related party transactions and its associated issues are key
- Transfer pricing documentation is usually required, in particular for cross border transactions
- Advanced Pricing Agreement (APA) may be considered if there is material uncertainty and the transaction will be significant

Effective Tax Rate

- In the past few years, governments are trying to maximize revenue from resources sector (driven by strong price)
- This resulted in challenges for mining companies operating in multiple jurisdictions to maintain (let alone reduce) their overall effective tax rate
- Detailed tax analysis is required to understand and model the impact of any increase in tax on certain project and to seek the opportunity to “offset” this increase with other taxes due (e.g. via a tax credit mechanism)
- The issue is now compounded by the decline in commodity prices, which results in more pressure for tax efficiency measures and control over tax overpayments

Our Publications

- Corporate income taxes, mining royalties and other mining taxes (June 2012) – www.pwc.com/gx/mining

- Tax transparency and country-by-country reporting - www.pwc.com/gx/en/tax/publications/tax-transparency-reporting.jhtml

- Mining in Indonesia - Investment and taxation guide (April 2012) - www.pwc.com/id/en/publications/assets/Mining-Investment-and-Taxation-Guide-2012.pdf

- Indonesian Pocket Tax Book 2012 - http://www.pwc.com/id/en/indonesian-pocket-tax-book/assets/Indonesian-pocket-tax-book_2012-update.pdf

Thank you